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ABSTRACT

This guide addresses the federal income tax considerations a college or university president faces as an employee and the special tax issues that arise by virtue of serving as the institution's chief executive officer. It does not contain information about state and local taxes, nor does it discuss the tax situation of the institution. Specific information is provided in chapters on: (1) federal taxable income; (2) fringe benefits; (3) federal taxable income; (4) deductions; (5) retirement, deferred compensation, and savings plans; (6) estate taxes; and (7) other compensation issues. (SLD)

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FEDERAL Income Tax GUIDE *for College & University Presidents*

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FEDERAL Income Tax GUIDE *for College & University Presidents*

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A Federal Income Tax Guide for College and University Presidents

The nature of a college or university presidency creates special federal income tax problems for the institution's chief executive officer. Although presidents share many of the same tax problems as other college and university employees, they also confront a variety of additional tax considerations. This tax guide will address those federal income tax considerations that a president faces as a college or university employee, as well as the special federal income tax issues that arise by virtue of serving as the institution's chief executive officer. College and university presidents should also become familiar with the state and local tax treatment of their income; because those rules vary with each state and locality, they are not discussed in this guide.

This tax guide was prepared initially by Bertrand Harding, Esq. for the American Council on Education and was revised by Carol G. Kroch and Stephen D. Hamilton of the law firm Drinker Biddle & Reath LLP.

TIAA CREF provided the information and research for the development of the material on retirement and estate planning.

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1. Federal Taxable Income

A. Concept of Gross Income

Gross income is the starting point for determining the taxable income of any taxpayer. The definition of gross income under the federal income tax laws is extremely broad and includes all items of value (in the form of money, property, or services) received by a taxpayer from whatever source derived, unless the item is excluded from gross income by a specific provision in the tax laws. For example, an amount received as a gift technically would constitute gross income to the recipient because it represents value received; however, a specific provision of the Internal Revenue Code excludes "gifts" from gross income.

College and university presidents may receive funds in many different forms, including wages, bonuses, service awards, scholastic awards, and honoraria, as well as non-monetary compensation, such as services or property. In considering whether a particular item is taxable, the IRS generally presumes that any payment from a college or university to its president constitutes taxable compensation. To rebut that presumption, the president must be able to point to a specific provision in the tax laws expressly excluding the particular payment from gross income.

Because this guide discusses federal income tax laws, references to the tax laws refer only to federal income tax laws. State and local tax consequences may differ from federal income tax treatment.

B. Compensation

Wages, salaries, and other forms of compensation for services paid by a college or university to its president are included in gross income. Compensation payments include sick pay, vacation pay, severance pay, and bonuses. Although bonuses may be awarded without reference to any specific service rendered, the IRS generally takes the view that bonuses are paid in consideration for prior or future services and therefore represent gross income subject to tax.

C. Awards

College and university presidents often receive awards in connection with their service to the institution or for academic or civic achievements. As a general rule, awards are included in an employee's gross income in an amount equal to any cash received. If the award consists of property or services, the fair market value of the property or services received is included in gross income.

There are, however, two exceptions to the general rule that awards represent gross income: "employee achievement awards" and awards that are given away by the president.

1. Employee Achievement Awards

For an employee achievement award to be excluded from an employee's income, the award cannot be made in cash; rather, it must consist of tangible personal property. Also, the award must be made to the employee either for length of service or safety achievement.

The value of a "length of service" award received by an employee may be excluded from gross income up to either $400 or $1,600 per year, depending upon whether the employee achievement award program discriminates in favor of more highly compensated employees (discriminatory plans are limited to the lesser amount). Also, a "length of service" award is excluded only if the recipient has completed at least five years of service and has not received a similar award in the current year or any of the preceding four years.

2. Gifts of Awards

If a college or university employee receives an award in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, the award can be excluded from the employee's gross income if the employee: (i) did not solicit the award; (ii) is not required to provide services in exchange for the award; and (iii) designates the award to be paid to a tax-exempt religious, charitable, scientific, literary, amateur sports, or educational organization (such as a private educational institution), or to a state college or university or other governmental organization. For example, a college or university president who receives a cash award for educational excellence and designates the award to be paid to his or her school's scholarship fund can exclude the amount of the award from gross income.

D. Honoraria

An honorarium typically involves a payment that is made to a person in exchange for services for which no specific fees were required or requested. Assume, for example, that a college or university president delivers a speech at a business convention without charge, and in appreciation of the president's speech, the sponsoring organization gives the president a cash honorarium. Arguably, the honorarium could be viewed as a "gift," which would be excluded from gross income. The IRS, however, most likely would consider the honorarium to be taxable compensation on the grounds that the honorarium would not have been paid "but for" the services rendered (i.e., the president's speech). If, however, the honorarium is paid directly to the president's college or university and is never offered to the president, the president would not be required to include the honorarium in gross income because the payment did not personally benefit the president.

E. Income from Affiliated Entities

College and university presidents may receive cash, goods, or services from organizations affiliated with their institutions, such as athletic organizations, booster clubs, alumni associations, foundations, and student societies. In general, the value of any item received from these organizations should be included in the president's gross income as compensation for services rendered. An issue that often arises in connection with these payments is which entity–the institution or the affiliated organization–is required to withhold taxes and file reports with the IRS. The answer will depend on the facts and circumstances of each case but will not affect the president's obligation to include the payment in his or her income. The payment will be includable in the recipient's income regardless of who is the "true payor."

2. Fringe Benefits

A. Overview

In addition to taxable forms of remuneration for services, educational institutions also provide their presidents with "fringe benefits." A fringe benefit is any benefit paid or provided to an employee other than salary, wages, or bonuses. Most colleges and universities provide the president with basic fringe benefits, such as group term life insurance, health insurance, and pension plan contributions. In addition, many college and university presidents receive more diverse benefits, such as complimentary tickets to athletic and cultural events, automobiles, campus housing, educational benefits, club memberships, and discounted use of university athletic facilities.

Because the broad scope of "gross income" includes all items of value received in whatever form derived, these fringe benefits theoretically could be included in a president's gross income. However, numerous provisions in the Internal Revenue Code specifically exclude many of these fringe benefits. These statutory exclusions fall into two general categories: (1) so-called "Section 132 fringe benefits," and (2) miscellaneous types of fringe benefits that Congress has determined should not be treated as gross income.

B. Section 132 Fringe Benefit Exclusions

In an attempt to create some consistency and simplicity in the treatment of fringe benefits, Congress in 1984 enacted Section 132 of the Internal Revenue Code. Section 132 essentially states that a fringe benefit will be taxable to the employee unless it qualifies under one of the special provisions set forth in the section. The particular Section 132 provisions that are relevant to college and university employees and presidents are described below.

1. The Working Condition Exclusion

Under the working condition exclusion, a fringe benefit is excluded from an employee's income so long as the fringe benefit serves a business purpose of the employee in his or her capacity as an employee of the college or university. This "business purpose" test is met if the employee would have been entitled to a business expense deduction if the employee had paid for the fringe benefit personally. For example, if a president receives a free airline ticket to attend a trustees' meeting, the value of the ticket is excludable as a working condition fringe benefit because the president could have deducted the cost of the ticket as a business expense that was incurred in his or her capacity as the president of the institution. The exclusion does not apply, however, to benefits that are provided to the president for personal reasons, such as personal entertainment expenses, because such expenses would not be deductible if the president had paid for them personally.

2. The No-Additional-Cost Service Exclusion

The no-additional-cost service exclusion allows employees to exclude from gross income the value of services provided by their employer for free or at a reduced cost, so long as providing the services does not cause the employer to incur substantial additional costs or to forego substantial revenue. For example, if a college or university has a recreational facility that is used by its students, the fact that it permits faculty and staff to use the facility without charge will not result in taxable income to the faculty and staff, so long as the school can show that it did not incur any substantial additional costs (or forego any substantial revenue) in permitting the faculty and staff use.

In order for any employee to qualify for the no-additional-cost service exclusion, the IRS regulations provide that the service provided must be in the same "line of business" in which the particular employee performs services. Clearly, this rule was written with for-profit corporations in mind. Consider, for example, a corporation that operates both a hotel and a financial services company. If the corporation provides free hotel rooms to employees who work in the financial services company, the free rooms will not qualify for the no-additional-cost service exclusion because the financial services company employees are in a different "line of business" than the hotel business. However, an employee performing substantial services in more than one line of business may exclude no-additional-cost services in all the lines of business in which he or she performs substantial services.

It is somewhat unclear, however, how this "line of business" requirement should be applied in the nonprofit college and university context. For example, can athletic department employees receive tax-free services from the computer systems department, or are they in different "lines of business" within the university? There are sound arguments that all college or university employees who work in an area that is part of the institution's broad educational mission (e.g., library, athletic department, bookstore, etc.) are in the same "line of business" and therefore are eligible for the no-additional-cost service exclusion.

3. The Qualified Employee Discount Exclusion

Under the qualified employee discount exclusion, an employer can provide its employees with a limited discount on goods and services without causing the discounted amount to be included in the employees' income as additional compensation. Under this exclusion, "services" that are provided to employees can be discounted up to 20 percent on a tax-free basis, and "property" can be sold to employees at cost without generating taxable income for the employees.

To illustrate this provision with respect to "services," assume that a school permits its employees to purchase computer programming services at a 25 percent discount. Under the qualified employee discount rule, the full discount value will not be included in income; rather, the first 20 percent of the discount will be excluded as a "qualified employee discount" and only the excess discount (5 percent) will be treated as taxable income to the employees.

Where an institution sells property to its employees at a discount, the employees must report income to the extent that the property is sold below cost. For example, assume that a college or university buys computers for $2,000 and sells them in the bookstore for $2,500. If the school sells the computers to employees for no less than $2,000, the discount arrangement will not generate

income; however, to the extent that the computers are sold for less than $2,000, the difference would not qualify for the qualified employee discount exclusion and would constitute taxable income to the employee.

Like the no-additional-cost service exclusion, the qualified employee discount exclusion also requires that the employee work in the same "line of business" as the discounted goods and services. However, an employee performing substantial services in more than one line of business may exclude qualified employee discounts in all the lines of business in which he or she performs substantial services. Again, while it is unclear how this "line of business" requirement should be applied in the college and university context, good arguments support the position that all college or university employees are in the same "line of business" and therefore are eligible for the qualified employee discount exclusion.

The qualified employee discount exclusion applies to "highly compensated employees" such as college and university presidents only to the extent that such employee discounts are available to all employees on substantially the same terms.

4. The *De Minimis* Benefit Exclusion

A fringe benefit qualifies for exclusion as a *de minimis* fringe benefit if its value is too small to justify the administrative burden of accounting for the benefit. Examples include coffee, doughnuts, or soft drinks furnished to employees; occasional theater or sporting event tickets; local telephone calls; and occasional supper money or taxi fare for overtime work. If, however, these minor benefits are provided on a frequent basis, then the value of those benefits, in the aggregate, may be substantial. When this occurs, a benefit of relatively small value will fail to qualify for the *de minimis* exclusion because the aggregate value is great enough to warrant accounting for the benefit.

The following section contains a discussion of these four Section 132 fringe benefit provisions in the context of benefits commonly provided by colleges and universities.

5. Application of Section 132 Fringe Benefit Provisions to College and University Fringe Benefits

a. Complimentary and Discounted Tickets to Athletic, Entertainment, and Cultural Events

Many colleges and universities provide their presidents with complimentary tickets to athletic, entertainment, or cultural events. If a college or university occasionally provides tickets to its president, then the value of the tickets or the discount may be excluded from the president's gross income as a *de minimis* fringe benefit. The *de minimis* fringe benefit exclusion does not apply, however, if an institution provides complimentary season tickets.

If a president is required to use the complimentary tickets to entertain persons having a business relationship with the college or university, then the tickets may be excluded as a working condition fringe benefit. However, this exclusion would not exclude the value of any tickets used to entertain the president's spouse, family members, or personal acquaintances. Also, in order to qualify as a working condition fringe benefit, the president must maintain adequate records showing that the tickets were, in fact, used for business purposes.

Colleges and universities also may provide their presidents with discounted tickets to athletic, entertainment, or cultural events. Historically, the IRS has treated tickets as products' under the qualified employee discount rules and has not taxed the employee if the tickets were sold at no less than cost. Recently, however, IRS agents have been treating tickets as "services," which would limit the tax-free discount amount to 20 percent of the tickets' normal selling price.

b. Club Memberships

Some colleges and universities provide their presidents with memberships in various types of clubs, such as country clubs, athletic clubs, etc., and the institution typically pays the dues for those clubs on behalf of the president. Historically, club memberships have been viewed as a working condition fringe benefit that could be excluded from the president's gross income. Tax law changes in 1993, however, significantly altered this interpretation.

As previously discussed, a working condition fringe benefit is excluded from income to the extent that the employee would be entitled to a business expense deduction if he or she had paid for the fringe benefit personally. Tax legislation enacted in 1993, however, provides that no deduction shall be allowed for membership dues in any club that is organized for business, pleasure, recreation, or other social purpose. According to the legislative history underlying this provision, this rule is intended to apply to all types of business, athletic, luncheon, and sporting clubs. Because this provision now bars a president from personally deducting club dues as a business expense, the statutory requirements for the working condition fringe benefit exclusion cannot be satisfied. Consequently, it is the IRS's position that club dues no longer qualify for exclusion as a working condition fringe benefit, even though there may be valid business reasons for the president to be a club member.

c. Personal Use of University Facilities

(i) RECREATIONAL FACILITIES

Many colleges and universities provide free or discounted use of recreational facilities to their employees, including the president. Recreational facilities may include athletic facilities, natatoriums, golf courses, racquet clubs, etc. It is usually possible to exclude from gross income the value of the president's personal use of these recreational facilities in a number of ways: as a no-additional-cost service fringe benefit, as a qualified employee discount, or under a special exclusion for an "employer-provided athletic facility."

The no-additional-cost service exclusion will apply if the employee's use of the facility does not result in any additional cost or foregone revenue for the college or university. This typically will be true so long as membership in the facility is not limited due to capacity. The qualified employee discount fringe benefit exclusion can apply if membership fees are discounted and, as previously discussed, the discount does not exceed 20 percent.

Under the special exclusion for an employee's use of an "employer-provided athletic facility," the value of the use of the facility is not included in the employee's gross

income if: (1) the facility is located on the employer's premises; (2) the facility is operated by the employer; and (3) substantially all of the use of the facility is by employees or their families. Often, the third test proves difficult to meet because use of the facility by non-employee students or the general public will disqualify the facility. If all of the tests are met, however, the facility should qualify, and use of the facility by the school's employees will not result in taxable income.

(ii) PERSONAL USE OF UNIVERSITY VACATION, RETREAT, OR CAMPING FACILITIES

Some colleges and universities provide an apartment, vacation home, camping facility, or other retreat facility to the president for his or her personal use. According to IRS regulations, a president's personal use of such facilities, even for a few days, will not qualify as a *de minimis* fringe benefit, and no other fringe benefit provisions apply to allow the president's personal use to be excluded from gross income. Therefore, a president generally will recognize gross income to the extent of the value of any personal use of such facilities.

d. Spousal Travel on Business Trips

It is not uncommon for a college or university to pay the travel costs for the president's spouse to accompany the president on a business trip. If there is no business purpose for the spouse's presence on the trip, the amounts paid for the spouse are includable in the president's gross income.

An issue arises, however, when there is a bona fide business purpose for the spouse to accompany the president. Under current tax law, the travel expenses of a spouse, dependent, or other person accompanying an employee are not deductible by a taxable employee unless: (1) the spouse, dependent, or other person is also an employee of the employer; (2) the spouse, dependent, or other person's presence on the trip serves a bona fide business purpose; and (3) the travel expenses would be otherwise deductible by the spouse, dependent, or other person. When these tests are met, the amount received should be treated as a reimbursed expense, subject to the rules discussed in Chapter 3.

e. Automobiles

Colleges and universities sometimes provide their presidents with automobiles that can be used for both business and personal purposes. The value of an automobile can be excluded from a president's income only to the extent that it is used in the discharge of the president's employment-related duties. The value of any personal use of the vehicle must be included in the president's gross income, unless the personal use is merely incidental to the president's employment-related duties, in which case the personal use can be excluded as a *de minimis* fringe benefit. If, however, the value of the president's personal use is included in gross income, the amount that must be included is generally determined either by the leasing cost of a comparable automobile or under a special valuation method set forth in the IRS regulations. If a college or university provides a chauffeur, the value of the chauffeur's services must be added to the value of the vehicle.

f. Computers

It is not uncommon today for colleges and universities to provide computers for their presidents that can be used while traveling or at home. The use of a home or portable computer may qualify as a working condition fringe benefit and be excluded from the president's gross income. However, if the computer is also used for personal purposes by the president or the president's family, an allocation must be made between business and personal use based on hours of use, and the value of the personal use must be included in the president's income, unless it is excluded as a *de minimis* fringe benefit. Strict substantiation rules apply to the business use of a computer, which may not be excluded as a working condition fringe benefit unless the president maintains adequate records as required under Section 274 of the Internal Revenue Code.

g. Flights on Institution-Owned or Chartered Aircraft

The value of flights taken by a president for personal purposes on an institution-owned or chartered aircraft must be included in the president's income. Similarly, if an aircraft is used for personal purposes by family members or friends of the president, the value of such use will be included in the president's gross income.

Of course, not all uses by a president of an institution-owned or chartered aircraft are for personal purposes. For example, presidents may use aircraft to travel between different campuses or to attend fund-raising, alumni, or other official events. These uses are not included in a president's income because they typically are treated as working condition fringe benefits–that is, the costs of the flights would be deductible by the president if they were paid for personally.

h. Subsidized Dining Rooms

The value of meals provided by a college or university to its employees in excess of the employees' cost can be excluded from the employees' gross income as a *de minimis* fringe benefit, provided that the dining facility is located on or near the school's premises and the revenue from the facility equals or exceeds its direct operating costs. In addition, the dining facility must not discriminate in favor of highly compensated employees, such as officers, directors, or trustees of the institution.

C. Miscellaneous Fringe Benefit Exclusions

In addition to the Section 132 fringe benefit exclusions discussed above, a number of other specific provisions in the Internal Revenue Code exclude particular types of fringe benefits from tax. Those specific exclusions that generally apply to college and university presidents are described below.

1. Personal Residence

Many colleges and universities provide a residence for their presidents. When the residence is provided under proper circumstances, its value can be excluded from the president's gross income.

Tax law specifically excludes from gross income the value of housing furnished to a president if the following requirements are satisfied: (1) the housing is furnished for the convenience of the college or university; (2) the president is required to accept such housing as a condition of his or her employment; and (3) the housing is on the business premises of the college or university. Failure to meet any one of these conditions will render this exclusion inapplicable, thereby causing the value of the housing to be included in the president's income.

The "convenience of the employer" test requires a direct nexus between the lodging that is furnished to the president and the business interests of the college or university. The "required as a condition of employment" test usually is met if, due to the manner in which the institution conducts its educational activities, the housing is necessary for the president to be available for longer than normal work hours, such as for on-campus meetings, fund-raising activities, alumni events, etc. The president's acceptance of housing need not be expressly required as a condition of employment (such as pursuant to a written contract), so long as the proper performance of the president's duties objectively requires, as a practical matter, that the president live in the college- or university-provided residence.

The third test–that the housing be "on the business premises" of the employer–is obviously met when the housing is physically located on campus. The issue sometimes arises, however, as to whether off-campus housing meets this test. If the off-campus housing either constitutes an integral part of a college's or university's operations or is a place where the president performs a meaningful portion of his or her duties, it may qualify as "on the business premises." The duties performed by a president at off-campus housing must be significant and not merely incidental in order for the housing to be treated as "on" campus. For example, in a 1983 court case, a college provided its president with a residence located four miles from the main campus. The president entertained business guests and occasionally held meetings, made telephone calls, and conducted college-related business in the residence. The court held that these occasional activities did not constitute a sufficient quantum of employment-related activity to find that the off-campus residence constituted "business premises" for purposes of the housing exclusion.

Because of concerns raised by colleges and universities as a result of this case, Congress enacted a special provision that provides a partial exclusion for college- or university-provided housing. This provision limits the amount of housing benefits that will be included in an employee's gross income to 5 percent of the housing's appraised value. A president or other employee of an educational institutional will qualify for the 5 percent limitation if the housing constitutes "qualified campus lodging"–that is, housing "located on, or in the proximity of" the campus and furnished for use as a residence. Thus, this provision partially alleviates income recognition for off-campus housing that does not meet the "on the business premises" test.

Many colleges and universities provide their presidents with lodging on more than one campus. The value of this housing also can be excluded from gross income so long as the president is required to use the campus residence in order to conduct business on behalf of the college or university, or on behalf of the particular campus, and does not use the housing for personal purposes.

2. Meals Provided for the Convenience of the Employer

In addition to the exclusion under Section 132 for subsidized dining rooms described above, tax legislation enacted in 1998 provides more generous rules for excluding the value of meals provided to employees on an employer's business premises. If more than one-half of the employees to whom meals are provided are furnished such meals for the convenience of the employer (as defined in Section 119), all meals will be treated as provided for the convenience of the employer. Thus, if the test is satisfied, the value of all such meals would be excludable from the employee's income.

3. Educational Assistance Programs

Many colleges and universities have adopted educational assistance programs covering some or all of the tuition costs of their employees, including the president or other senior officials. Under current law, up to $5,250 of employer-provided educational assistance (other than for graduate-level courses) can be excluded from income each calendar year, assuming certain requirements are met. Any amount received in excess of $5,250 of employer-provided educational assistance is included in an employee's gross income. It should be noted, however, that this provision is scheduled to expire on December 31, 2000. Individuals should check with their personal tax advisors to see whether the educational assistance provision (Section 127 of the Internal Revenue Code) has been extended beyond that date.

4. Tuition-Reduction Programs

Under a tuition-reduction program, an institution reduces its own tuition for the benefit of an employee, an employee's spouse, or an employee's dependent or pays the tuition for any of these individuals to attend another educational institution. Such tuition reductions will qualify as tax-free scholarships to the extent that the reduction consists of tuition, fees, books, supplies, and required equipment. Amounts for room, board, or incidental expenses, however, are included in the employee's gross income. A qualified tuition reduction plan will be nontaxable to the employee only if it does not discriminate in favor of highly compensated employees. In addition, the exclusion generally applies only to undergraduate education. A tuition reduction for graduate-level work will qualify for the exclusion only if the individual receiving the reduction is a graduate student who is engaged solely in teaching or research activities.

5. Life Insurance

Group term life insurance provided by a college or university to its president is, within certain limitations, not taxable to the president. Specifically, an employee can exclude from gross income the cost of up to $50,000 of group term life insurance on the employee's life under a policy carried directly or indirectly by the employer. This exclusion applies regardless of the fact that the employee can designate the policy's beneficiary. The cost of employer-provided coverage in excess of $50,000 must be reported as gross income.

In addition to providing group term life insurance coverage, life insurance contracts sometimes are used by colleges or universities as financing mechanisms to provide additional compensation benefits to their presidents. These executive compensation arrangements include: (1) bonus life insurance plans; (2) split-dollar insurance plans; and (3) salary continuation plans. Under a bonus

life insurance plan, the college or university pays a bonus to its president to assist him or her in purchasing personal life insurance coverage. A split-dollar life insurance plan is similar, with the exception that the college or university retains some rights or control over the policy. For example, a split-dollar life insurance plan may be used to finance the premium payments on a whole life insurance policy for a president, with the college or university retaining rights to a portion of the policy's death proceeds. Finally, salary continuation plans sometimes use life insurance to finance a deferred compensation plan.

It is important to note that although life insurance contracts are used to finance these benefits, the benefits received by employees under these plans do not qualify for the "life insurance" exclusion. These compensation devices are complex and involve difficult tax issues. A college or university president should have such plans reviewed carefully by a professional tax advisor before participating in any arrangement of this type.

3. Federal Taxable Income

A. Exclusions for Expense Reimbursements

Because "gross income" generally includes all items of value received by an employee, when an employee receives a reimbursement from his or her employer for business expenses incurred–such as airfare, meals, or lodging–the reimbursement payment technically constitutes gross income to the employee. A reimbursed employee business expense can be excluded from gross income, however, if it is made pursuant to a reimbursement or expense allowance arrangement (known as an "accountable plan") under which the employer requires the employee to substantiate all expenses and repay any amounts received in excess of the substantiated expenses.

In order to qualify as an "accountable plan," the following tests must be met: (1) reimbursements can be made only for business expenses incurred by the employee in connection with the performance of the employee's duties; (2) the plan must require employees to substantiate their expenses within a reasonable period of time; and (3) the plan must require employees to repay any reimbursements that exceed substantiated expenses within a reasonable period of time. If these tests are not met, the full amount of the reimbursement is included in the employee's income. The employee then may claim the reimbursed expenses as a miscellaneous itemized deduction, but such deductions are allowed only to the extent to which they exceed 2 percent of the employee's adjusted gross income.

4. Deductions

An employee can claim several different types of expenses as deductions to reduce his or her gross income. Some expenses are deducted directly from gross income, resulting in an amount referred to as "adjusted gross income." Other so-called "itemized expenses" are deducted from adjusted gross income to determine "taxable income." This latter category of expenses can be deducted only if the employee itemizes the expenses on his or her individual income tax return, and many of those expense deductions are subject to percentage limitations or other restrictions. As a result of these deduction "hurdles," some itemized expenses may be deducted only in part or possibly not at all.

As previously discussed, if a president is reimbursed by an institution for expenses incurred in the carrying out of official responsibilities, those reimbursements are not included in the president's gross income (assuming that the "accountable plan" rules are met). Correspondingly, those reimbursed expenses cannot be deducted on the president's individual income tax return. A deduction may be available, however, for certain business-related expenses that are not reimbursed by the college or university or for expenses that are reimbursed but are not remitted under an accountable plan. Certain of these expenses are "miscellaneous itemized deductions," which must be itemized and only are deductible to the extent that, in the aggregate, they exceed 2 percent of the taxpayer's adjusted gross income.

A. Travel, Meal, and Entertainment Expenses

In order for an employee to deduct expenses for travel, meals, and entertainment as business expenses, the Internal Revenue Code requires that extensive substantiation be maintained. In general, a taxpayer must substantiate with contemporaneous records the following elements for each expenditure: (1) the amount of the expenditure; (2) the date, time, and place of the travel, meals, or entertainment; (3) the business purpose served by the expenditure; and (4) the business relationship to the taxpayer of each person entertained. If these requirements are not satisfied, the IRS can disallow the claimed deduction in full.

In addition to the substantiation requirements, entertainment and travel expenses can be deducted only under limited circumstances, and lavish or extravagant entertainment expenses cannot be deducted. Moreover, entertainment expenses can be deducted only if an employee is able to establish that the expenditure was directly related to, or associated with, the active conduct of his or her employment-related duties.

An entertainment expense is "directly related to" the active conduct of business if the employee actively engages in bona fide business discussions during the entertainment and does not provide the entertainment merely to create goodwill–in other words, the principal character of the combined business and entertainment activity must be the conduct of business. Accordingly, expenses incurred in connection with certain entertainment events where there is little or no possibility of engaging in

business discussions (such as at a nightclub, theater, sporting event, country club, golf club, athletic club, or resort) generally cannot be deducted.

An entertainment expense is "associated with" the active conduct of business when the entertainment activity directly precedes or follows a substantial and bona fide business discussion. Entertainment that occurs on the same day as a business discussion is treated as directly preceding or following the discussion. In order to qualify, the principal character of the combined business and entertainment activity must be the active conduct of business–i.e., the business discussion must be substantial as compared with the entertainment activity.

The expenses of a business meal, when the meal occurs under circumstances generally considered conducive to business discussion, are generally deductible so long as the employee is present during the meal. Although such meal expenses must bear some rational relationship to business pursuits, they are not subject to the rigorous "directly related to" or "associated with" tests that are applied to entertainment expenses.

Finally, assuming that a college or university president can satisfy all the above requirements for meal and entertainment expenditures, the Internal Revenue Code provides that only 50 percent of those expenses may be deducted, subject to the 2 percent adjusted gross income (AGI) threshold for miscellaneous itemized deductions described above.

B. Other Limitations on Travel Expenses

An employee may deduct expenses incurred while traveling, including reasonable amounts expended for meals and lodging while away from home overnight in the conduct of business. For example, for a college or university president, the travel must be in furtherance of the institution's educational purposes. Travel that is undertaken primarily for personal purposes cannot be deducted. Generally, expenses for meals or lodging incurred in the course of non-overnight travel are not deductible, although transportation expenses may be deducted.

If a president travels outside the United States for business purposes and also engages in personal activities, a portion of the travel costs may be disallowed unless the travel does not exceed one week or less than 25 percent of the travel time is spent on personal activities. If those conditions are not satisfied, the IRS may allocate the travel expenses between deductible employee business expenses and nondeductible personal expenses. In addition, no deduction is allowed for expenses incurred in attending a convention, seminar, or similar meeting held outside of North America unless the taxpayer establishes that the meeting is directly related to his or her work as an employee and that it is as reasonable for the meeting to be held outside North America as within it.

The deduction for travel expenses is subject to the 2 percent AGI threshold for miscellaneous itemized deductions described above.

C. Organization Dues and Club Memberships

Presidents of colleges and universities frequently incur dues for memberships in professional societies or associations as well as social, sporting, or athletic clubs. As a general rule, dues paid to business organizations, such as a labor union or professional association, will be an itemized deduction that is deductible to the extent that the dues (when combined with other employee business expenses) exceed 2 percent of the president's adjusted gross income.

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As previously discussed, no deduction is currently allowed for membership dues paid to a club that is organized for business, pleasure, recreation, or other social purpose. Accordingly, a president may not deduct club dues as an employee business expense. Also, specific business expenses incurred while at a club (e.g., meals and entertainment) are deductible only to the extent that the expenses otherwise qualify as properly substantiated employee business expenses.

The IRS has released regulations that provide examples of what it considers social organizations; these include, but are not limited to, country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs operated to provide meals under circumstances generally considered conducive to business discussion. The deduction for allowable membership dues is subject to the 2 percent AGI threshold for miscellaneous itemized deductions described above.

D. Charitable Contributions

A president, like any other individual taxpayer, may claim a deduction for contributions of cash or property to a charitable organization. The allowable deduction for a contribution of appreciated property held for more than one year generally equals the property's fair market value on the date of contribution, while the deduction for a cash contribution will be the amount of cash donated. These deduction amounts, however, may be limited in several respects.

A president's overall deduction for charitable contributions is subject to certain percentage limitations on his or her "contribution base," which is usually the president's adjusted gross income. The deduction is capped at either 30 percent or 50 percent of the contribution base, depending on the type of organization to which the contribution is made. Contributions in excess of the applicable percentage limitation can be deducted in future years. There are additional limitations if a president makes charitable gifts of capital assets that have appreciated in value.

Under current tax law, no deduction will be allowed for a contribution of $250 or more unless the taxpayer is able to substantiate the contribution with a contemporaneous written acknowledgment from the donee organization. Contributions made during a year to the same charitable organization, however, generally will not be aggregated for purposes of meeting the minimum $250 threshold. The acknowledgment must include: (1) the amount of cash or a description (but not the value) of any property contributed; (2) whether the charity provided any goods or services as consideration for any property contributed; and, if so, (3) a description and good faith estimate of the value of any such goods or services provided. A taxpayer's canceled check is not an acceptable substitute for an acknowledgment. These substantiation requirements will not apply, however, if the charitable organization itself reports the value of the contributions to the IRS.

As noted above, the charitable contribution deduction for a donation of property is usually equal to the property's fair market value. Special rules, however, limit the deductibility of tangible property, unless the donee uses the property for a related purpose. Thus, as a general rule, a taxpayer who contributes appreciated property to a charitable organization is entitled to a charitable deduction for the fair market value of the property determined on the date of the contribution but is not taxed on any appreciation in the property's value. Consequently, the taxpayer receives a substantial tax benefit by contributing appreciated property to a charitable or educational organization.

In prior years, this benefit was limited by the alternative minimum tax (AMT), which effectively limited the donor's charitable deduction for AMT purposes to his or her basis in the property. However, a 1993 tax law change repealed this limitation.

E. Interest Deduction for Residence Not Provided by the University

A college or university president may maintain a personal residence in addition to the residence provided by the school. Moreover, not all institutions provide the president with residential housing, and consequently, the president may personally own a residence. Under either scenario, the president would be entitled to a deduction for interest paid on the home's mortgage.

Interest on indebtedness incurred in acquiring, constructing, or substantially improving a qualified residence and secured by the residence is deductible, provided that the aggregate amount of this indebtedness does not exceed $1,000,000. A "qualified residence" includes both a president's principal residence and a second residence designated as such by the taxpayer. A president may elect to have any residence treated as a second "qualified residence" but may not have more than one second residence at any particular time.

In addition, interest on home equity indebtedness is deductible. This includes any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent that the debt does not exceed the fair market value of the qualified residence, reduced by the amount of any outstanding acquisition indebtedness secured by such residence. The aggregate amount of home equity indebtedness may not exceed $100,000.

F. Education Expenses

A president may deduct educational expenditures incurred to: (1) maintain or improve skills required in his or her employment, or (2) meet any legal requirements of the college or university that are necessary for the president to retain his or her employment, status, or rate of compensation. In this regard, expenditures incurred for courses dealing with current developments and academic courses are considered deductible, as are expenses for tuition, books, supplies, laboratory fees, and certain travel and transportation costs. The deduction for allowable educational expenses is subject to the 2 percent AGI threshold for itemized deductions described above.

Other educational expenditures, however, are considered personal in nature and therefore are not deductible. Such personal education expenses include expenses incurred: (1) to meet the minimum educational requirements for qualification to hold the position of president, or (2) as part of a program of study that will qualify the president for a new line of employment.

Frequently, educational pursuits involve travel. Expenses for travel as a form of education in and of itself are not deductible. If a president travels away from home to obtain educational training, however, expenditures for travel, meals, and lodging while away from home are deductible. The travel must occur primarily for educational purposes; if a president's travel away from home is primarily for personal reasons, then the expenditures for travel, meals, and lodging (other than for meals and lodging during the time spent participating in educational pursuits) are not deductible. Even if the travel is primarily for educational purposes, expenses attributable to incidental personal activities (e.g., sightseeing, social visiting, entertaining, or other recreation) are not deductible.

G. Automobile Expenses

An employee can deduct the portion of automobile expenses attributable to business (as opposed to personal) use. This deduction is determined by identifying the total amount of automobile expenses incurred during a taxable year and multiplying this amount by the percentage of the year's mileage

devoted to business use. Deductible expenses would include such costs as fuel, oil, lubrication, washing, maintenance, repairs, tires, supplies, parking fees (but not fines), tolls, taxes, license tags, and insurance. Deductible costs do not include repairs that either prolong the useful life or increase the value of the vehicle; the cost of these items must be recovered through depreciation deductions, which are discussed below. In addition, the expense of commuting to and from work is not a deductible cost.

The Internal Revenue Code provides an optional method for computing an automobile expense deduction if the employee owns the automobile. Under this method, the deduction may be computed at a standard mileage rate, which for 1998 was 31.0 cents per mile and for 1999 is 32.5 cents per mile. A deduction computed under this optional method will preclude a deduction for other costs incurred in operating the vehicle during that year, other than parking fees and tolls and state and local personal property taxes. The deduction for allowable automobile expenses is subject to the 2 percent AGI threshold for miscellaneous itemized deductions described above.

H. Depreciation Expenses

When a president purchases an item that will be used in performing his or her duties as president and is not reimbursed for the cost of the item by the institution, the president can either: (1) deduct the full cost of the item in the year in which it was acquired under the "employee business expense" deduction rules described above, or (2) treat the item as a so-called "capital asset" and deduct its cost through annual depreciation deductions over a period of years. In general, an item having a useful life of more than one year must be treated as a capital asset.

The amount of the annual depreciation deduction is determined by the Internal Revenue Code and depends upon the type of property acquired. For example, automobiles and computers generally are depreciated over a five-year period, whereas office equipment, furniture, and fixtures are depreciated over a seven-year period. There are additional limitations on the depreciation of luxury automobiles, assets that are not used solely for business purposes, and assets that are used for only a portion of a year.

A president may also elect under Internal Revenue Code Section 179 to deduct some or all of an item's cost for the year in which it first is used for business purposes. Under this election, a president can deduct the cost of tangible personal property used in the performance of his or her duties as president, up to a maximum of $18,500 per year in 1998 (as indexed for inflation in subsequent years).

Under an additional limitation, property that is "listed property" may be depreciated and/or expensed only to the extent that such items are: (1) acquired for the convenience of the employer and (2) required as a condition of employment. Listed property includes, but is not limited to, automobiles, computers, and cellular telephones. The deduction for allowable depreciation expenses is subject to the 2 percent AGI threshold for miscellaneous itemized deductions described above.

I. Home Office Expenses

A college or university president may reside in a home that is not provided by the institution but that is owned by the president personally. If the president also maintains an office in the home, a deduction may be available under very limited circumstances for expenses attributable to that home office. The president must use the home office exclusively for college or university business, and the office must be used on a regular basis as the president's principal place of business and as a place where the president normally meets with persons having a business relationship with the college or university. Accordingly,

the home office must be the most important and significant place in which the president conducts college and university business. If, as in most cases, however, the president maintains an office on campus or elsewhere, it is unlikely that a home office business deduction will be allowed. The deduction for allowable home office expenses is subject to the 2 percent AGI threshold for miscellaneous itemized deductions described above.

5. Retirement, Deferred Compensation, and Savings Plans

Generally, retirement and most savings plans fall under the category of deferred compensation plans, in which employees receive benefits in subsequent years for amounts of compensation earned currently. The scope of programs discussed in this chapter includes employer-sponsored retirement plans, savings plans–such as 403(b), 401(k), and 457(b) plans–and other deferred compensation arrangements, as well as non-employment-related tax-favored savings incentives. Some of these plans are elective–for example, those in which the president can choose to participate and use to delay compensation. Under other types of plans, the amount of deferred compensation is determined by a formula that the president (or any individual) cannot alter; these are referred to as non-elective plans. Other aspects to consider include who pays for the plan and the tax treatment of contributions and benefits.

A. Employer-Sponsored Retirement Plans

Most presidents are covered by either a defined contribution retirement plan or a defined benefit retirement plan, while some, depending on their employment history, may be covered by both types of plans. In a defined benefit pension, the amount of benefit at retirement age is determined by a formula that relates final (average) earnings to years of service multiplied by a percentage specified in the plan. State retirement systems that cover public university employees and (in many states) college employees are defined benefit plans. Using a different approach, a defined contribution plan sets aside a certain percentage of compensation in an account in which contributions and earnings are tax deferred and can be converted into a lifetime income. The majority of pension plans at private colleges are defined contribution plans, and almost all states have an option allowing presidents, faculty, and other employees to participate in a defined contribution pension plan.

The Internal Revenue Code permits tax-deferred retirement savings benefits. Some retirement plans are known by the specific section of the tax code that applies to such plans. For example, Section 403(b) plans in higher education can serve a dual purpose: retirement plans for employer and employee contributions as well as tax-deferred annuity plans for voluntary employee before-tax savings. Most colleges use 403(b) plans to provide the president's retirement benefits, although in recent years a number of colleges–especially those in the public sector–have established their defined contribution plans as qualified plans under Section 401(a). State retirement systems usually operate as qualified plans.

The president, like any other employee, can be covered by a university's retirement plan. However, because the president is likely to be considered a highly compensated employee, he or she cannot be treated more favorably than others covered by the retirement program. The tax code generally limits the amount of compensation an employer can include under its retirement plan for determining contributions and benefits. For 2000, that amount of earnings is capped at $170,000. Thus, any compensation paid to a president in excess of $170,000 must be disregarded in determining the amount of retirement plan contributions that can be made on his or her behalf each year. This $170,000 limit is

adjusted yearly for cost-of-living increases, but only when such increases amount to at least $10,000. However, presidents and other employees participating in a public sector pension plan by 1996 may have plan contributions based on their full salary (provided the relevant state legislature took appropriate action to allow this special provision).

The tax code also limits the amount an employer can contribute to a defined contribution retirement plan. Specifically, under the annual limits in Section 415, no more than $30,000 (indexed) or 25 percent of compensation may be contributed by the employer and employee to a defined contribution plan. In addition, if the retirement plan operates under Section 403(b), then the amount contributed by both the employer and the employee cannot exceed the maximum exclusion allowance. The retirement plan contribution percentages at most colleges and universities fall within these limits, but some presidents may be limited by the $30,000 annual cap on contributions. While many defined contribution plans specify a level percentage for contributions, some plans offer a "step formula" that increases the rate of contribution above a certain level of compensation (usually the SSWB) or makes increased contributions based on age or number of years of service. Such differences are allowed as long as the retirement plan can demonstrate compliance with nondiscrimination rules.

If the president is employed by a public college or university, he or she may participate in the state retirement system with a formula benefit at retirement age. The defined benefit formula usually provides for a fixed monthly or yearly benefit based upon the participant's average annual compensation and length of service with his or her employer. Many state and public retirement systems require employees to contribute to their plan–under Section 414(h) "pickup"–so employees can obtain pre-tax treatment. Defined benefit pension plans are subject to limits on the annual benefit payable to a participant. In general, a participant's projected annual benefit at social security retirement age is limited to the lesser of 100 percent of the participant's average compensation in his or her highest paid three consecutive years of service or $135,000 (as currently adjusted for increases in the cost of living).

Under Section 401(a)–"tax-qualified" retirement plans–contributions to fund benefits generally are made each year by the institution to be held in trust or annuity contract until distributed to the participant at retirement or other termination of employment. Defined benefit plans, some state optional retirement plans for higher education employees, and a small number of defined contribution plans at private colleges are operated as "qualified." As described above, a Section 414(h) "pickup" enables presidents at public colleges to make any mandatory plan contributions before tax. Generally, in the private sector, contributions cannot be made to "qualified" plans by the president or other employees of the institution on a pre-tax basis through salary reduction, so those pension plans that are operated under Section 401(a) are non-contributory. 401(k) plans are an exception, and pre-tax contributions to qualified retirement savings plans are allowed.

If a president is covered under two or more pension plans, they must be aggregated (under certain circumstances) when applying the limitations on contributions. For example, contributions to 403(b) retirement and tax-sheltered annuity programs generally are aggregated with the president's contributions to his or her personal Keogh plan, which is based on any outside self-employment income. However, if employer contributions for the president are allocated to an institution's tax-qualified retirement plan, they generally do not have to be aggregated with contributions to the same employer's 403(b) annuity program. Rather, the 403(b) contributions have their own separate $30,000/25 percent of compensation limit. As a result, the president and other employees may receive a larger total contribution under a combined program consisting of a tax-qualified retirement plan and a 403(b)

tax-sheltered annuity than if they were covered by a 403(b) retirement plan and a tax-deferred annuity plan. Also, aggregation is required if Special Election C is made.

B. Voluntary Retirement Savings Through 403(b), 401(k), and 457 Plans

When an institution offers a 403(b) tax-deferred annuity (TDA) program for its employees, the president generally must be eligible to participate in the plan. Under a TDA plan, the president can exclude from his or her gross income, within limits, contributions to an annuity contract or a custodial account. These contributions, made by the president on a pre-tax basis through salary reduction, often are called "elective deferrals."

Under the tax code, 403(b) salary reduction contributions, subject to three separate IRC limits under Section 415, are considered part of the annual contributions made to the retirement savings plan by the employer and may not exceed the lesser of 25 percent of the president's compensation for the year or $30,000. The contributions also are subject to the Section 403(b) maximum exclusion allowance (MEA). Under the MEA, the amount of allowable 403(b) contributions depends on factors such as the amount of the president's includable compensation, prior contributions to any plan of the employer, and number of years of service. Further, in applying the Section 415 limitation, contributions to a tax-deferred annuity program ordinarily must be aggregated with contributions made to the president's Keogh plan (if any) based on his or her outside self-employment income (e.g., consulting fees, book royalties, director's fees). Also, the 403(b) elective deferrals are subject to a separate annual dollar limit (indexed for increase in the cost of living); this amount is $10,500 for the year 2000. For those employees who have completed 15 years of service with an educational institution, the $10,500 limit may be increased (but not by more than $3,000 in a year). Elective deferral to a 403(b) plan must be aggregated with other TDA-type arrangements, such as 401(k) and 457 plans, of any employer for the 402(g) limit.

To operate tax-deferred plans in compliance with these complex rules, consideration should be given to calculating the president's maximum permissible contribution each year and then redoing such calculation during the year if there is any change in his or her salary, bonus, or other relevant contribution factors. Unlike Section 401(k), the nondiscrimination rules that apply to 403(b) elective deferrals focus only on availability to make contributions and not the actual amount of TDA contributions, so a president can take full advantage of his or her individual deferral possibility, irrespective of what other employees contribute.

Some private institutions have added profit-sharing plans, commonly known as 401(k) plans, because of a change in the tax law that allowed private-sector nonprofit employers the opportunity to save before-tax in a qualified plan. (A tax-exempt organization may maintain and contribute to a profit-sharing plan without affecting its tax-exempt status, even though the organization lacks a profit motive.) Under a 401(k) arrangement, a president may elect to have a portion of his or her compensation contributed to the plan on a pre-tax basis through a reduction in his or her salary. Like 403(b) TDAs, the amounts saved as elective deferrals and the earnings in 401(k) plans are not includable in gross income until they are distributed. A few states established 401(k) plans for public employees before Congress restricted that option; those plans are grandfathered.

To satisfy nondiscrimination standards, the amounts contributed to 401(k) plans for highly compensated employees must be within a specified range of the average deferred amounts contributed by non-highly compensated employees. As a result, many presidents may only be able to put aside a small percentage (5 to 6 percent) of their salary in a 401(k) and may not be able to use the full $10,500 limit

on elective deferrals in the 401(k) plan. In addition, elective deferrals made by a president to 401(k), 403(b), and 457 plans of any employer must be combined for the purpose of applying the $10,500 limit.

Salary reduction contributions to the 403(b) and 401(k) plans are excluded from the president's gross income, and taxation of contributions and earnings on such amounts are postponed until benefit payments are made to the president or his or her beneficiary. Distributions generally can only be made when the president dies, attains age 59 1/2, separates from service with the institution, or becomes disabled. A distribution that is made upon separation from service with the institution will be subject to a 10 percent penalty tax, unless the president: (1) separated from service after age 55; (2) receives life annuity payments; or (3) rolls the distribution over to another tax-sheltered annuity plan or individual retirement account. However, hardship distributions of salary reduction contributions (no earnings) may be permitted under the plan. In addition, loans may be available under the plan. In any event, distribution generally must commence when the president attains age 70 1/2 or at actual retirement.

While both public- and private-sector nonprofit employers may sponsor 457 deferred compensation plans, these plans are more prevalent in the public sector as a way of offering employees the opportunity to save money on a before-tax basis. Deferred compensation plans that satisfy the requirements of 457(b) plans often are referred to as "eligible" deferred compensation plans. Some presidents also may consider participating in an "ineligible" deferred compensation plan under Section 457(f) (discussed in Section C).

Amounts contributed to 457(b) plans are not subject to federal taxation until they are actually paid to the president. The $8,000 limit on deferrals to 457(b) plans is lower than the $10,500 amount for 403(b) and 401(k) plans, with which such deferral must be coordinated. An "eligible" deferred compensation plan has a special catch-up rule that permits presidents higher contributions if they are close to retirement. Because the deferral limits for 457 plans are reduced by dollar-for-dollar contributions made to 403(b) retirement plans as well as TDA contributions, they are less attractive to many college presidents.

Prior to 1999, 457(b) plans were simply an unfunded promise to make payments in the future. Subsequently, Congress required 457(b) assets of public employers to be maintained in a trust (or annuity) for the exclusive benefit of participants. Most 457(b) plans are elective, although they may be offered on a non-elective basis. Compensation deferred under an eligible plan may not be paid or made available to a president prior to the calendar year in which he or she attains age 70 1/2, separates from service, or is faced with an unforeseeable emergency. Also, certain minimum distributions must begin by April 1 of the calendar year following the year in which the president attains age 70 1/2 or retires (whichever is later).

C. Other Deferred Compensation Arrangements

Given that Section 457 governs deferred compensation arrangements in both the public and the nonprofit sectors, these arrangements are much more limited than those available in the for-profit sector. For this reason–and because the tax laws in these areas are changing rapidly–presidents and boards considering forms of deferred compensation should consult with private counsel in order to identify the best arrangement. Deferred compensation arrangements include the following:

1. Qualified "Governmental Excess Benefit Plans"

The limits in the tax code may restrict the amount of contributions that a college or university may set aside for a president under its retirement plan or tax-deferred annuity. In 1996, Congress created Qualified Government Excess Benefit Plans to allow state and local entities to contribute amounts that would have been contributed to a basic retirement plan but were cut back due to Section 415 limits, such as the annual limit of 25 percent of compensation or $30,000 (whichever is lower) for defined contribution plans. Retirement benefits that would have exceeded these limits can be contributed to an unfunded excess benefit plan. A governmental excess benefit plan must use the compensation limits that apply to the employee–either the general $160,000 or the grandfathered amount for public employees participating before January 1, 1996. Amounts would be distributed according to the underlying retirement plan.

2. Ineligible 457 Deferred Compensation

Because of the limits on contributions to "eligible" 457 plans, many college and university presidents have considered so-called ineligible plans under Section 457(f). Contributions to 457(f) plans are not limited in amount. To avoid inclusion as taxable income, all contributions to an arrangement under Section 457(f) must be subject to a "substantial risk of forfeiture." Generally, this means that a future service requirement must be stated as a condition of receiving the benefits, such as continuing to work for an organization until a future age or date, or the employee will forfeit all rights to the benefits. Assets in these 457(f) arrangements must reside under the ownership of the employer and are subject to the claims of creditors of the employing organization. However, deferred compensation funds can be set aside from the employer's general assets through institutionally owned annuity contracts or certain trust arrangements referred to as "rabbi trusts." Presidents must weigh these risks against the benefit of deferring taxation. Boards may find that 457(f) arrangements encourage presidents to remain at the college or university, thereby creating a "golden handcuff."

Compensation deferred under a Section 457(f) plan will be includable in the employee's gross income in the first year it is not subject to a substantial risk of forfeiture. In the year that the substantial risk of forfeiture lapses, the employee must include the deferred compensation in income for tax-reporting purposes as well as, possibly, earnings accrued through that date if they are paid or made available to the president at that time. The institution may withdraw the full amount of the contract and then make a cash payment equivalent to the entire amount of the deferral and earnings to the employee. In some cases, the institution may retain control of the assets so the president can avoid immediate inclusion of the earnings, but a properly designed plan should provide executives with cash sufficient to meet the tax liability when the risk of forfeiture lapses.

D. Non-Employment-Related Personal Savings Incentives

1. Traditional IRA

A college or university president who has not attained age 70 1/2 and who has earned income during the year may make deductible or nondeductible contributions to an individual retirement account (IRA) for that year. A president also may contribute to an IRA for his or her non-working spouse under age 70 1/2 if: (1) the president and spouse file a joint income tax return for the year and (2) the compensation, if any, of the non-working spouse for the year is less than the

compensation of the working spouse (the president). IRA contributions may not exceed $2,000 per year per individual, or $4,000 total per year for both spouses, and may be made as late as the due date for filing the taxpayer's federal income tax return for that year (excluding extensions).

The deductibility of IRA contributions depends on: (1) whether the IRA owner or, in some cases, the spouse of the IRA owner was an "active participant" in a retirement plan sponsored by his or her employer and, if so, (2) the amount of his or her modified adjusted gross income (AGI). Usually, a president who is an active participant may not deduct contributions to his or her IRA because the president's AGI typically will exceed the income limits for deducting IRA contributions. (For example, the deduction for such contributions for 2000 begins to phase out at an AGI of more than $52,000 and is eliminated at $62,000 for a person filing a joint return.) However, the earnings on any nondeductible contributions to an IRA will grow on a tax-deferred basis.

Amounts held in an IRA are not subject to federal income tax until they are distributed from the account. If nondeductible contributions were made to the IRA, a portion of each IRA distribution would be treated as a return of the nondeductible contributions and, therefore, would not be subject to federal income tax. Distributions from a traditional IRA must begin by April 1 of the year following the year in which the account owner attains age 70 1/2. Generally, distributions before the account owner attains age 59 1/2 are subject to a 10 percent early withdrawal tax, unless the distribution is attributable to the account owner's death or disability; is used to pay certain "first-time homebuyer" expenses, health insurance premiums of certain unemployed persons, medical expenses in excess of a certain amount, or qualified higher education expenses; or is paid either in the form of an annuity or in substantially equal lifetime installments (not less frequently than annually).

2. Roth IRA

The Taxpayer Relief Act of 1997 created a new type of IRA called the Roth IRA. Although contributions to a Roth IRA are not deductible, withdrawals are federal tax-free if the Roth IRA has been established for at least five years and if the account owner satisfies a qualified reason, including attainment of age 59 1/2, death or disability of the account owner, or use of the IRA to pay certain "first-time homebuyer" expenses.

The annual contribution limit to a Roth IRA is $2,000 per individual ($4,000 for both spouses). The $2,000 annual contribution limit is gradually reduced to $0 for single individuals with a modified AGI between $95,000 and $110,000 and for joint filers with a modified AGI between $150,000 and $160,000. The contribution limit is also reduced by the amount of any contributions made to the account owner's traditional IRA.

A president may convert an amount held in his or her traditional IRA to a Roth IRA if the president's modified AGI (single or joint filers) for the tax year is $100,000 or less. Conversion is not an option for single or joint filers with a modified AGI in excess of $100,000 or for a married individual filing separately. The taxable amount of the conversion is includable in the president's gross income in the year of conversion.

3. Education IRA

In addition to the Roth IRA, the Taxpayer Relief Act of 1997 created the Education IRA, which may be used to accumulate funds to pay the qualified higher education expenses of the beneficiary of the account. The maximum amount that may be contributed annually cannot exceed $500 per child (the child must be under age 18). The $500 annual contribution limit is gradually reduced to $0 for joint filers with a modified AGI between $150,000 and $160,000 and for other filers with a modified AGI between $95,000 and $110,000. Although contributions to an Education IRA are not deductible, the contributions grow tax-free until they are distributed, and the beneficiary will not owe federal income tax on any distribution that is used to pay his or her qualified higher education expenses for that year. The earnings portion of a distribution in excess of the beneficiary's qualified higher education expenses will be subject to federal income tax and an additional 10 percent tax. Any balance remaining in the Education IRA on the date the beneficiary attains age 30 must be distributed to the beneficiary and will be subject to federal income tax and the additional 10 percent tax (unless the balance is rolled over to the Education IRA of another family member).

4. Qualified Tuition Plans Under Section 529

Almost all of the states have established either a prepaid tuition plan or a tuition savings plan as described in Section 529 of the tax code. Amounts contributed to these 529 accounts are made with after-federal-tax dollars. Some states allow a state income tax deduction for contributions. Distributions from tuition plans that benefit from an increase in the value of tuition fees purchased in a prepared plan and investment earnings in a savings plan are taxed at the student's tax rate, not that of the owner–provided the distributions were used to meet the student's qualified education expenses. Amounts withdrawn and not used for education expenses are subject to income tax at the owner's tax rate as well as a penalty imposed by the tuition plan. No income limits restrict who is eligible to establish a 529 tuition plan for a beneficiary; in fact, many states provide local income tax incentives. An owner may transfer the assets in a 529 plan to another qualifying beneficiary within his or her family.

E. Pension Changes Under Consideration

In 1999, Congress passed a major tax bill that was subsequently vetoed by the president. A number of pension provisions that have bipartisan support were part of that bill and likely will surface for reconsideration during the second session of the 106th Congress. Proposed pension law changes would increase the annual amount that can be contributed to retirement plans, raise the level of covered compensation to $200,000, eliminate the 25 percent of compensation limit and the 403(b) maximum exclusion allowance, and allow Roth IRA treatment for elective deferrals to 403(b) and 401(k) plans. Proposed changes would create additional opportunities for employees over age 50 by allowing them to save 50 percent more than the dollar limit on elective deferrals by creating a special "catch-up" election. While it is difficult to determine the likelihood of these changes taking effect, presidents should be sure to check with their tax advisors as to the effect of any changes in the tax treatment of retirement and savings plans.

6. Estate Taxes

A. Transfer Taxes and the Relationship to Estate Planning

A discussion of tax issues and planning would not be complete without an understanding of the transfer tax system. Transfer taxes include gift, estate, and generation-skipping taxes. Gift taxes are imposed upon lifetime taxable gifts. Estate taxes are imposed upon property transferred at death. Generation-skipping taxes are imposed upon property that skips a generation.

Estate planning works to accomplish two main goals: preserving wealth and transferring wealth in accordance with one's wishes. Understanding the transfer tax rules is important to each of these goals. The process of estate planning involves defining where you would like your assets to end up at your death, identifying the taxes and other costs that might reduce the amount, and then arranging for one or more of the estate planning tools (wills, trusts, gifts, beneficiary designation forms, and insurance policies) to get your property where you want it to go at the lowest possible cost.

B. Basics of Transfer Tax Laws

Your estate consists of all your property, including life insurance death benefits and the remaining value of your retirement annuities, minus liabilities. At the outset, it's important to realize that every estate plan is different. For that reason, be wary if you hear that there's some estate planning tool that everyone should use. Equally important, the general discussions of planning techniques in this manual should stimulate thought but not lead to action unless you've consulted with a qualified professional.

C. Gift Taxes

There are two concepts to remember when considering lifetime gifts: the **annual exclusion** and the **unified credit**. On an annual basis, you can gift up to $10,000 to any number of donees. You and your spouse as a married couple (if both are U.S. residents) can jointly give $20,000 per year to each donee, as of 1999. The annual exclusion amount is indexed for inflation after 1998, but has been projected to remain at $10,000 for 2000.

In addition to the annual exclusion, there is an unlimited gift tax exclusion for medical expenses and tuition costs paid by the donor on behalf of the donee. The payments must be made directly to the medical service provider or a qualifying educational institution.

> *Example:* Chancellor Jones' parents have a large estate and wish to reduce their taxable estate through lifetime gifting. Their grandchildren attend private educational institutions. The grandparents pay for their grandchildren's tuition by making payments directly to the educational institution. In addition, they each make $10,000 annual exclusion gifts to each of the children and grandchildren.

Contributions to Education IRAs are not considered taxable gifts for federal gift-tax purposes. Similarly, Education IRA distributions are not treated as taxable gifts.

There is an unlimited marital deduction for purposes of the unified gift and estate tax. Therefore, U.S. citizen spouses may freely transfer property between each other. The marital deduction provides a planning opportunity by allowing spouses the potential to equalize their estates through lifetime gifting without incurring federal gift taxes.

Every individual has a certain amount of lifetime or estate transfers that can be made free of transfer taxes. This amount is referred to as the unified credit. In 2000, the unified credit is an amount sufficient to shelter estate and gift taxes due on $675,000 worth of taxable assets. The unified credit is cumulative and will increase annually to a maximum of $1,000,000 in 2006. Your taxable estate is generally increased by any taxable gifts made during your lifetime.

Unified Credit Increase by Year	Unified Credit	Exclusion Amount
2000 and 2001	$220,550	$675,000
2002 and 2003	$229,800	$700,000
2004	$287,300	$850,000
2005	$326,300	$950,000
After 2005	$345,800	$1,000,000

The gift tax rates are the same as the estate tax rates–which is why the rates are referred to as "unified." As mentioned previously, the gift and estate taxes are cumulative. Any previous taxable gifts, made after June 6, 1932, affect the tax due on current taxable gifts.

If you make taxable gifts in excess of $10,000 per donee, you must file a federal gift tax return by April 15 of the following year. There are some limited exceptions to the filing requirements. The amount due is the calculated tax less the amount of remaining unified credit. (See Unified Estate and Gift Tax Rates Table, page 31.)

There are advantages and disadvantages to lifetime gifting. The primary advantages are: (1) post-gift appreciation is not subject to gift or estate taxes and (2) gift taxes paid on gifts made more than three years before death will not be subject to estate tax.

> *Example:* College President Smith has made lifetime gifts using up the entire unified credit. After annual exclusion gifts, Smith gifts stock worth $20,000 to her son. Smith is in a 50 percent transfer tax bracket and pays $10,000 on the gift. Smith dies five years later. The stock gifted to the son is then worth $100,000. Therefore, no transfer taxes were paid on the asset appreciation of $80,000. In addition, transfer taxes were minimized because the payment of taxes during the individual's lifetime worked to reduce the overall taxable estate.

There are some obvious disadvantages to lifetime gifting. First, the donor will lose the enjoyment and control of the property forever. In order for a gifted asset to be excluded from your estate, the gift must

Unified Estate and Gift Tax Rates Table

Column A *Taxable amount over*	**Column B** *Taxable amount not over*	**Column C** *Tax on amount in Column A Column A (%)*	**Column D** *Rate of tax on excess over amount in*
$0	$10,000	$0	18%
$10,000	$20,000	$1,800	20%
$20,000	$40,000	$3,800	22%
$40,000	$60,000	$8,200	24%
$60,000	$80,000	$13,000	26%
$80,000	$100,000	$18,200	28%
$100,000	$150,000	$23,800	30%
$150,000	$250,000	$38,800	32%
$250,000	$500,000	$70,800	34%
$500,000	$750,000	$155,800	37%
$750,000	$1,000,000	$248,300	39%
$1,000,000	$1,250,000	$345,800	41%
$1,250,000	$1,500,000	$448,300	43%
$1,500,000	$2,000,000	$555,800	45%
$2,000,000	$2,500,000	$780,800	49%
$2,500,000	$3,000,000	$1,025,800	53%
$3,000,000	.....	$1,290,800	55%

be a complete transfer and you cannot retain beneficial enjoyment of the property. Second, the income tax basis to the donee will generally be the same as the donor's cost increased by any gift tax paid. For determining a loss on the sale of gifted assets, the donee's basis will be the lesser of the donor's basis or the fair market value of the property at the date of the gift. The carryover basis issue is an important factor to consider due to the "step-up in basis" rules. The step-up rule says that property acquired from a decedent will have an income tax basis equal to the fair market value at the decedent's date of death. Therefore, the individual receiving a gifted asset may have a larger gain when selling the asset then if it had been received through an estate. Another disadvantage may be the early payment of transfer taxes.

D. Estate Taxes

The gross estate includes assets in your probate estate and nonprobate assets. The probate estate is property that has to be distributed under court supervision. Nonprobate assets include property that passes automatically as the result of some other arrangement, such as an annuity or life insurance contract with a named beneficiary (other than the estate or the legal representative of the decedent's estate), jointly held property, or some trusts. To estimate the value of your gross estate, you need to add up the value of your liquid assets (such as cash, checking and savings accounts, and money market accounts), stocks and bonds, personal effects and other assets, real estate, death benefits from retirement plans, and life insurance policies.

For annuities that are in the accumulating stage, the value of the annuity on the date of death will be included in the gross estate. If you are currently receiving annuity income, the value of the survivor benefit or of the remaining income through the guaranteed period will be included in the gross estate.

Life insurance is also included in your gross estate if you have the right to name the beneficiary, transfer the policy, borrow from the policy, or exercise other powers associated with ownership. Specialized estate planning tools, such as the irrevocable life insurance trust (ILIT), can be used to remove life insurance from your estate. But, until an ILIT is implemented, life insurance must be considered part of the gross estate.

There are special valuation rules for property that you own with a spouse. In general, this is determined by the laws of the state in which you live, even for federal estate tax purposes. In community-property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington), spouses are generally considered to be co-owners of any property acquired during marriage. In common-law states (most other states), spouses are not considered co-owners of property unless it has been jointly titled, but surviving spouses are entitled to inherit a portion of the deceased spouse's property.

If you own property as a joint tenant with your spouse, only one-half of its value is considered part of your estate (a special rule applies to property acquired before 1977; consult with your advisor). When your partner in joint tenancy is not your spouse, property is assumed to be completely owned by you unless proven otherwise (based on contributions by your joint tenant).

For real estate, the laws of the state in which the property is located governs ownership. If real estate in another state is titled in your name individually, probate in that state is typically required to transfer title after your death. For this reason, the use of a trust may be helpful. For personal property–including your investment accounts–your local state law generally will determine ownership.

Although there are certain deductions that can be made from the gross estate before determining the taxable estate, these are generally more limited than income tax deductions. Generally, the taxable estate is determined by subtracting from the gross estate the unlimited marital deduction for bequests to spouses and the deduction for bequests to qualified charities. Deductions include "last expenses" –medical expenses, funeral costs, and other related expenses. Administration costs–such as attorney, accountant, executor, and appraisal fees–may also be deductible. Debts also reduce the taxable estate and include mortgages, income tax liabilities, and state death taxes.

E. Generation-Skipping Taxes

Another type of federal tax that may affect your estate is the generation-skipping transfer (GST) tax. It's applied to gifts or bequests that "skip" a generation–a gift of property from grandparent to grandchild, for example. The tax is 55 percent of the value of the transferred property. However, there's a GST tax exemption on the first $1,010,000 that's transferred. This exemption is indexed each year for inflation.

F. Estate Planning Tools

Although each person's estate plan is unique, there are basic estate planning tools that, used together, may be appropriate for many plans. It is helpful to have a basic understanding of them when forming your estate plan.

The Will

Your will is the legal document in which you state what happens to your probate estate. Your will cannot dispose of your nonprobate assets, such as jointly owned property, life insurance with a named beneficiary, or any asset or account that will automatically pass to a named beneficiary.

At the beginning of their careers, some people feel there's no need for a will because they don't own very much and it's all jointly owned with the spouse anyway. Unfortunately, anyone who believes this could be making two mistakes.

The first is to think that the only purpose of the will is to say where your property goes. In the will, you also name an executor, the person legally empowered to wind up your financial affairs after your death. You want to avoid ambiguities regarding your executor, particularly if you've got assets that need to be taken care of right away. And although there's no legal requirement to do so, a will is usually the appropriate place to designate a guardian of your minor children and their property if both you and your spouse should die. This is true even if all of your property is jointly owned or will not otherwise require probate administration.

A second mistake is to overlook what would happen if both you and your spouse, or the primary beneficiary in your will, were to die in a common accident. If it can be shown that one of you outlived the other, even for a short period of time, then all the property could go to the survivor's family or to the designated beneficiary in his or her will. If this isn't the arrangement you'd like, you and your spouse (or your primary beneficiary) must ensure you have wills that clearly spell out how your property should be distributed.

A will may not be enough. Once you have a will, you may still have addressed only part of your basic estate planning needs. The problem is that a "simple will" (an expression that usually means a will without a trust) may say who your executor is and where your property is going, but it won't do much to save taxes or expenses associated with settling your estate.

The Trust

A trust is simply a legal device, available to anyone, designed to hold the property of an individual (the "grantor") for the sake of one or more beneficiaries. The grantor names a "trustee"—an individual and/or institution—to manage the trust's assets according to his or her instructions for the benefit of the trust beneficiaries. Trusts are useful for resolving different kinds of estate planning issues. They can be used to avoid probate on assets transferred to the trust during your lifetime or to reduce the taxes associated with settling your estate. They can help support your surviving spouse and children, assist family members with special needs, or provide for your future care.

Revocable trusts allow you to control your assets and change the terms of the trust at any time; irrevocable trusts do not.

Beneficiary Designation Forms

One of the most common estate planning problems is when someone rewrites a will but neglects to rewrite the various beneficiary designation forms applicable to insurance, annuities, retirement plans, and the like. Since the law won't presume that your rewritten will is intended also to amend these designations, they must all be reviewed when you revise your will or revocable trust.

The Marital Deduction and Credit Shelter Trust

One fundamental estate planning technique is the proper use of the marital deduction. The marital deduction is equal to the fair market value of qualifying property passing to a surviving spouse, provided he or she is an American citizen. However, there are two ways a noncitizen spouse can receive assets tax-free. Assets can be left in a "qualified domestic trust." Also, while you're alive, you can give your noncitizen spouse up to $101,000 (for 1999) per year free of gift tax. This amount is indexed for inflation, but at the time of this release it is not certain whether this amount will be changing.

Because the marital deduction only defers the estate tax until the surviving spouse dies, there could be a significant tax obligation after the survivor's death. If you and your spouse have a large estate, it may be worthwhile to do some careful planning now.

> *Example:* Using your respective unified credits, you and your spouse can each currently shelter up to $650,000 from federal estate taxes. You may therefore think that together you have exemptions totaling $1.3 million. This isn't automatic. For instance, suppose you and your spouse have combined assets worth $1.3 million, and one of you dies, leaving everything outright to the other. While there's no federal estate tax at that time because of the unlimited marital deduction, the surviving spouse has the full $1.3 million in his or her estate, though only $650,000 can be sheltered from estate tax. In this example, estate tax of $211,300 will be due at the survivor's death. With proper estate planning, the entire tax balance could have been eliminated.

To use your unified credit more effectively, consider not leaving property to your spouse outright or in a mutual trust–at least not the amount that can be sheltered from estate tax by your unified credit. Leave it instead to a trust that doesn't qualify for a marital deduction.

A credit shelter trust is specially designed to give your surviving spouse the benefit of your assets during his or her lifetime, while not including them in his or her estate. Your spouse can write the same kind of document for your benefit, in case he or she dies before you. This will ensure that, no matter who dies first, your respective unified credits will be fully utilized.

Although this kind of trust has several different names, the most precise term for it is credit shelter trust because it helps protect the tax shelter benefit of the unified credit for the first spouse to die. It's sometimes called a "B" trust to distinguish it from the marital deduction trust, which is called an "A" trust, into which you'd put the excess of your estate over $650,000. It's also referred to as a bypass trust, because it lets part of the estate of the first spouse to die bypass taxes in the estate of the second spouse to die.

There are many misunderstandings about this type of trust. You need to be clear at the outset that its purpose is usually not to keep assets away from your spouse, but only to keep them from being taxed to his or her estate. This trust can provide for income to the survivor (and, if desirable, can even give to the survivor some limited power of disposition to other people and/or the power to take out each year the greater of $5,000 or 5 percent of the trust principal), and property in this trust will generally escape taxation at the survivor's death. Of course, if you wish to put restrictions on your spouse's access to the trust, or to make some or all of it for the benefit of your children or other people–completely excluding your spouse–you can do that too.

Caution: One of the most important things to do after signing a will or trust that creates a credit shelter trust is to make sure each spouse has sufficient assets in his or her name to fund the credit shelter amount ($650,000 in 1999). If all your assets are jointly owned or titled to the spouse who survives, then the credit shelter trust is worthless. That's because all the assets will go outright to the survivor automatically or will already be owned by him or her, and nothing will go into the trust. From a tax point of view, the ideal scenario is for each spouse to own individually roughly the same amount of property in his or her name. The tax advantage of owning property in one's own name must be weighed against the creditor and divorce laws.

Qualified Terminable Interest Property Trust

The qualified terminable interest property trust (QTIP) differs from the marital deduction trust in that no requirement exists in the QTIP situation that the spouse be given an "all events" general power of appointment. Further, the spouse need not be given a lifetime power of appointment. Otherwise, the trusts require similar administrative provisions. The QTIP trust is particularly advantageous in the situation where the decedent has children by a former marriage because that decedent can control the disposition of his estate upon the death of the surviving second spouse. For example, the property can be distributable at the death of the surviving spouse to the first deceased spouse's surviving children from a prior marriage and without any power of appointment being held by the surviving spouse to redirect those assets to other beneficiaries.

Irrevocable Life Insurance Trust

As mentioned previously, one common way to avoid estate taxes on insurance proceeds is to purchase and own your life insurance through an irrevocable life insurance trust. The irrevocable life insurance trust is set up to be the owner and the beneficiary of the life insurance policy. The trust terms generally distribute the insurance proceeds to your family the same way as, or in a way that's complementary to, the rest of your estate plan. Because you don't have control over the policy, however, it's not subject to estate taxes.

The gift tax value of a life insurance policy is generally much lower than the face value of the policy. The cash surrender value of a policy often approximates the gift tax value of a policy. Therefore, the transfer can be made for gift tax purposes at a very low cost, but the amount of estate taxes avoided may be substantial. Another advantage of the gift of a life insurance policy is that the loss of control is not a significant issue for the owner compared to other types of assets.

Caution: First, not all irrevocable trusts are alike. You'll want to make sure yours is set up by an attorney who specializes in estate planning, so that the document accomplishes exactly what you're looking for. Second, if you transfer an existing policy to such a trust, there's a three-year waiting period before the transfer is effective for transfer-tax purposes. This means you're better off having the trustee of the irrevocable life insurance trust buy a new policy that will be held in the trust, rather than purchasing the policy yourself and then transferring it to the trust.

Caution: Prior to canceling a life insurance policy, make sure that you have confirmation that you are still insurable and that the new policy has been issued.

Charitable Bequests and Trusts

Lifetime transfers to charitable organizations are not subject to gift taxes, and estate transfers to charitable organizations reduce the taxable estate. A charitable bequest is written into your will or trust and takes place at your death.

Charitable trusts can be created during your life or at your death. A charitable remainder trust pays an annuity income to a noncharitable income beneficiary, and the remainder pays to the charity. The donor receives a charitable deduction based on the actuarially computed remainder interest. A charitable lead trust provides annuity income to the charity as an income interest. Noncharitable beneficiaries receive the remainder interest. In certain cases, the donor receives a charitable deduction based on the actuarially computed income interest. Assets used to fund these types of trusts generally have a low yield and substantial built-in gain. This allows an individual to make a charitable gift while creating a greater income stream from the asset without recognizing income taxes on the sale of the asset.

Another planning opportunity is using retirement benefits for charitable giving. Retirement benefits remaining after your death are included in your estate for estate tax purposes. Whoever inherits these benefits will have to pay income taxes on any income received. Directing that retirement benefits be used for your charitable bequests is an effective strategy because your estate will receive an estate-tax charitable deduction, and the charitable organization will avoid income tax. You can also leave taxable retirement benefits–such as annuity death benefits–to charities, which, because of their tax-exempt status, will not be taxed on them.

Note: When evaluating the use of charitable bequests and lifetime charitable gifts, a gift that is made during your lifetime will generally provide greater overall tax savings. This is due to the fact that you receive an income tax deduction in the year of the gift. Thus, your estate taxes are reduced because the asset is removed, and your income tax liability is reduced as well.

Other Common Planning Trusts and Entities

There are many types of estate planning techniques that utilize trust instruments. Examples of these tools are qualified personal residence trusts, grantor retained annuity trusts, and defective trusts. These tools tend to have more complex provisions and some can be subject to increased IRS review. Many trusts include provisions that utilize generation-skipping transfer tax exclusion opportunities.

In the last several years, there has seen an explosion in the use of family limited partnerships and limited liability companies. At the same time, the IRS has been actively scrutinizing these transactions due to the substantial tax savings that can be achieved. These techniques can result in valuation discounts based on certified appraisals. To be recognized for tax purposes, the entity and its owners must meet business and tax entity classification rules. The assets contributed to the entity and diversification rules can affect the amount of the discount and other income tax provisions.

G. Non-Tax Estate Planning Issues

Although estate planning usually involves planning for the disposition of your assets following your death, there's been a growing interest in contingency planning for incapacity.

A living will is an advance written directive regarding medical treatment if at some time in the future you're dying, comatose, or otherwise unable to express your wishes. There are also documents that let you name a person to authorize medical treatment or request that it be withheld. This type of document

is sometimes referred to as a health care proxy, but its name, as well as its scope, varies from state to state.

A person who wants to plan ahead for possible incapacity can execute numerous documents. These include the basic living will directing when life-sustaining measures should be withheld, the appointment of a specific person to decide whether to withhold these measures, the appointment of a person to make other health care decisions if you are unable to make them yourself, the designation of a conservator in case one is needed, a power of attorney, and a direction regarding anatomical gifts–that is, bodily organs donated to science. It's possible in some states to execute these documents separately or combined into a single legal document.

Here is a review of some of the instructions that may be included in your state's forms, along with suggestions for determining whether they're right for you.

The Traditional Living Will
Although some people refer to all advance directives as living wills, the traditional living will is really something more specific. A true living will contains document language related to the withholding or withdrawal of life-support systems if you are irreversibly unconscious and dying. Although many people have signed such documents, some people prefer to give the authority for withholding treatment to specified individuals (usually family members), rather than to the treating physician.

Health Care Proxy
This is where you name a particular person to make decisions on your behalf. Some states lump all decisions together, while others authorize the creation of two separate designations–one for a health care agent (which names the person who authorizes the withholding of life-sustaining measures) and another for a power of attorney for health care decisions (which names the person who authorizes other medical decisions).

Power of Attorney
Although you may decide that there's one individual you want to make your health or life-and-death decisions, you may decide that you want a different person to manage your financial affairs during any period of incapacity before your death. Though some state forms make a hazy distinction between the power of attorney and the health care proxy, don't forget that you can make your personal instructions as specific as you like.

Long-Term Care Considerations
The need for long-term care services can place a heavy financial burden on families. The risks of needing long-term care increase with age, and a financial plan that does not include funding for long-term care can place an individual's retirement savings in jeopardy if care is needed.

E. Most Common Estate Planning Mistakes

Many individuals do not realize that regardless of whether they have wills and trusts, estate planning has already been done for them. That is because state laws operate when documents do not address transfer issues. Many issues can be easily addressed by consultation with an estate tax attorney. The cost of professional fees can be minimal in comparison to the tax savings that can be achieved and the comfort of knowing your goals will be achieved.

Understanding What is in the Estate
Every individual should evaluate their own estate. This includes details such as fair market value, tax basis, and ownership titling.

Lack of Estate Documents
Every individual should have a will and/or trust document that addresses issues such as asset disposition, executor and trustee duties, and payments of estate expenses. Durable powers of attorney and health care are critical to ensure that management of financial affairs during incapacity and at death are made in accordance with your wishes.

Changes in Family Personal and Economic Circumstances
The birth of children or grandchildren, retirement, serious illness, change of residence to a new state, divorce, and receipt of an inheritance are examples of events that may impact existing estate documents or require the drafting of new ones.

Asset Ownership
The titling of assets is critical to the determination of a taxable estate. Assets with beneficiary designations or rights of survivorship will operate outside of estate documents. Trusts that are drafted to meet certain estate planning goals will not achieve those goals if they are not funded with the assets intended for them. This would also include the improper use of jointly held property. The effect of state creditor and divorce laws should be taken into consideration.

Liquidity Needs
After an individual's death, a certain amount of cash or liquid assets may be needed to cover taxes and other costs of transferring property at death. This would include planning for the proper amount of life insurance coverage and insurance ownership.

Trustee and Executor Selection
Naming the wrong person to administer a trust or estate can be disastrous. The person who administers the trust and/or estate must collect assets, pay obligations, and distribute assets to beneficiaries. This is no easy task. It can be highly complex, time consuming, and in some cases technically demanding.

7. Other Compensation Issues

A. Federal Intermediate Sanctions Rules

Tax-exempt universities and colleges, like all section 501(c)(3) organizations, are prohibited from making payments to insiders that constitute "private inurement." Excessive compensation paid to a president or other non-fair market value transactions between a college or university and its president could result in private inurement. Before enactment of the intermediate sanction rules (IRC §4958) in 1996, the sole remedy for violation of the private inurement prohibition under section 501(c)(3) was revocation of exemption–a draconian remedy that was seldom used. Proposed regulations implementing the intermediate sanctions rules were issued on August 4, 1998. However, they have received extensive comment, and the IRS does not expect to issue final regulations until early 2000. This section briefly considers the impact of these rules on college and university presidents.

Section 4958 imposes an excise tax on "excess benefit transactions" engaged in by certain tax-exempt organizations, including colleges and universities. An excess benefit transaction is a transaction in which an organization such as a college or university provides an economic benefit directly or indirectly to or for the use of any "disqualified person" if the benefit provided exceeds the value of the consideration, including the performance of services, received for providing such benefit. Under proposed regulations, an excess benefit transaction also would include certain revenue-sharing arrangements between organizations such as colleges and universities and a disqualified person, if the arrangement results in prohibited inurement.

Under these rules, an economic benefit will not be treated as compensation unless the organization clearly indicates its intent to treat it as such by contemporaneously reporting the compensation on relevant forms, such as Form W-2 or Form 1099 (reporting the payment to the recipient) and the Form 990 Annual Information Return. Non-tax fringe benefits need not be reported, although such benefits will be included in total compensation when analyzing the reasonableness of the compensation. An organization cannot wait until an IRS audit to establish that it intended to treat economic benefits as compensation for services, and the proposed regulations so provide.

The excess benefit tax applies only to excess benefits provided to "disqualified persons," who are defined as:

- Any person who at any time during the five years preceding a transaction was in a position "to exercise substantial influence over the affairs of the organization";
- A family member of such individual; and
- A corporation, partnership, or trust or estate in which persons with substantial influence or members of their family own more than 35 percent of the total combined voting power, profits interest, or beneficial interest.

While it may be difficult to determine whether some employees are disqualified persons, a college or university president generally has substantial influence over his or her institution, and the proposed regulations presume that any president or CEO will be a disqualified person.

The tax consequences of paying an excess benefit to a disqualified person are severe. First, the disqualified person must pay an initial excess benefit tax equal to 25 percent of the excess benefit. In addition, a tax of 10 percent of the amount of the excess benefit (limited to $10,000 for any one transaction) is imposed on organization managers who participate in the transaction, unless the participation is not willful and is due to reasonable cause. Thus, a college or university president could be liable both for receiving excessive compensation and for participating in the decision to pay excessive compensation to other disqualified persons. Furthermore, if the excess benefit transaction is not "corrected," an additional 200 percent penalty tax is imposed on the disqualified person receiving the benefit. Under the statute, correction means "undoing the excess benefit to the extent possible and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards."

Section 4958 is effective retroactively to transactions occurring on or after September 14, 1995. It will not apply to benefits arising out of a transaction pursuant to a binding written contract as of September 13, 1995, provided that the terms have not materially changed. Proposed regulations were issued on August 4, 1998; when finalized, they will be effective retroactively. However, new rules regarding revenue-sharing arrangements will become effective upon publication of the final regulations.

Although the intermediate sanction rules heighten the possibility that a penalty will be applied to private inurement transactions, the legislative history and the proposed regulations also provide a significant planning opportunity for the organizations subject to the new rules. The committee report and the proposed regulations state that parties to a transaction may rely on a rebuttable presumption of reasonableness with respect to a compensation arrangement with a disqualified person if the arrangement was approved by the organization's board of directors or trustees (or a committee of the board) as long as the board or committee:

- is composed entirely of individuals who do not have a conflict of interest with respect to the proposed transaction;
- obtains and relies upon appropriate data as to comparability (e.g., compensation levels at similar taxable and tax-exempt organizations, the availability of similar services in the geographic area, independent compensation surveys by independent firms, actual written offers from similar institutions competing for the services of the person, and independent appraisals); and
- concurrently documents the basis for its determination by noting the terms of the transaction and the date of approval, the members of the board or committee present during discussion and those who voted, the comparability data obtained and relied upon and how they were obtained, and actions taken by any board or committee member who had a conflict of interest with respect to the transaction.

A special rule for organizations with annual gross receipts of less than $1 million permits them to establish comparable data by obtaining data on compensation paid for similar services by five comparable local organizations.

Once the rebuttable presumption is established, the IRS may impose penalty excise taxes only if it can develop sufficient contrary evidence to rebut the presumption. A similar rebuttable presumption would also apply with respect to the reasonableness of the valuation of property sold or transferred if the sale or transfer is approved by an independent board or committee that uses appropriate comparability data and adequately documents its determination.

In addition to heightening the importance of listing all compensation on Form W-2, the new rules also require organizations to report on their annual Form 990 the amount of any tax paid by the organization or any disqualified person on excess benefit transactions and any other information required by regulations regarding the transactions and the disqualified persons.

B. Estimated Tax Payments Required for Income Not Subject to Withholding

Unlike salaries and wages, some types of income are not subject to automatic withholding. These include interest, dividends, and realized capital gains on sales or exchanges of real or personal property. The IRS requires that the income taxes on such items be remitted during the course of the year.

In general, an individual must remit, in quarterly installments, either 90 percent of the tax shown on the return for that year or 100 percent of the tax of the preceding year in order to avoid a penalty for underpayment of estimated taxes. However, in the case of individuals with adjusted gross income in excess of $150,000 ($75,000 for married individuals filing separately), the estimated tax safe harbor must be based on payment of an amount greater than the prior year's tax liability, as follows:

If the preceding taxable year begins in:	The applicable percentage of prior year tax liability is:
1998	105%
1999 or 2000	106%
2001	112%
2002 or thereafter	110%

Generally, an individual is required to pay 25 percent of this annual amount in quarterly installments due on April 15, June 15, September 15, and January 15 of each year. If, however, an individual does not receive income evenly over the course of the year, then an "annualized" method can be employed to determine the amount of estimated taxes that should be remitted. This method usually evens out the tax liability over each quarter to reflect more accurately the actual receipt of income.

C. Accounting and Recordkeeping Requirements

Like most employees, college and university presidents report their income and deductions to the IRS according to the "cash basis" method of accounting. Under the cash basis method, income is reported to the IRS during the year in which it is actually received, and deductions are claimed during the year in which the expenses are actually paid. Under the doctrine of "constructive receipt," however, amounts that are not actually received may nonetheless be included in income. Under this doctrine, an amount

must be included in an employee's taxable income when it is effectively within the control of the employee, such as when income is set aside for the employee or otherwise made available so that he or she may use the income at will.

Every person subject to federal income tax must maintain complete and accurate records of income and expenses, and the form of those records will depend upon the type of income or expense being substantiated (e.g., charitable contributions or entertainment expenses). Records for a particular tax year should be maintained for at least as long as the statute of limitations for that year will run.

The statute of limitations limits the number of years in which the IRS can assess additional taxes on a taxpayer. In general, the IRS must assess additional income taxes for a particular year within three years after an individual files an income tax return for that year. For example, if a taxpayer files his or her 1998 tax return on April 15, 1999, the statute of limitations for the 1998 tax return will expire on April 15, 2002. If, however, a taxpayer omits from gross income an amount that is more than 25 percent of the gross income reflected on the tax return, then the IRS has six years after the filing of the return to assess additional taxes. Accordingly, a college or university president, like any other individual taxpayer, should maintain tax records for at least three years after a return is filed; to be safe, the records should be kept for at least six years. Copies of the tax returns themselves should be kept permanently.

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